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MUNICIPAL BANKRUPTCY AMENDMENTS

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Mr. BIDEN, from the Committee on the Judiciary, submitted the following

REPORT

[To accompany S. 1863]

The Committee on the Judiciary, to which was referred the bill (S. 1863) to amend the municipal bankruptcy law to correct the inconsistencies between the existing bankruptcy law and municipal law, having considered the same, reports favorably thereon with an amendment and recommends that the bill do pass.

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I. PURPOSE

The bill amends the Bankruptcy Code, 11 U.S.C. Section 101 *et seq.* The purpose of the bill is to clarify the provisions of the Bankruptcy Code applicable to municipalities and to correct unintended conflicts that currently may exist between municipal law and bankruptcy law. The proposed amendments reflect principles that have long been the premise for municipal finance but that have not been expressly stated in the Bankruptcy Code. The proposed amendments would dispel the confusion which has resulted from the general statement in Section 901 of the Bankruptcy Code that

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Sections 547, 552 and 1111(b) are currently applicable to a Chapter 9 case. Those sections were originally drafted with regard to corporate and individual bankruptcies and incorporated by reference in Section 901 of the Bankruptcy Code. Their effect on a municipal bankruptcy due to the unique nature of municipal finance was never considered by the drafters of the Bankruptcy Code.

II. Legislative History

The Bankruptcy Reform Act became public law on November 6, 1978. This was the first major revision of the bankruptcy code since the 1938 Chandler Act amendments passed 40 years ago. On March 14, 1979, Senator DeConcini introduced S. 658, the Bankruptcy Technical Amendments of 1980. The purpose of the legislation was to correct technical errors, clarify and make minor substantive changes to the 1978 Act. The bill was referred to the Subcommittee on Improvements in Judicial Machinery and the subcommittee favorably reported the bill to the full committee. On July 31, 1979, the bill was ordered reported. S. 658, as reported, included an amendment to "provide protection for the holders of the revenue bonds of a political subdivision or agency." The report clarified that the disparity in treatment in the 1978 Act between secured creditors of a muncipality versus a corporation "was not intended." S. 658 did not contain all the provisions that are currently embodied in S. 1863, but it was the first attempt to address the concerns of municipal bankrutpcy. The bill was officially reported on August 3, 1979.

On September 7, 1979, the Senate passed the bill without objection.

On October 1, 1979, the Bankruptcy Reform Act of 1978 became effective.

S. 658 was sent to the House and subsequently referred to the House Subcommittee on Civil and Constitutional Rights of the House Judiciary Committee. The subcommittee held hearings and included witnesses on municipal financing as affected by the changes in Chapter 9.

The subcommittee reported S. 658 with amendments on June 13, 1980. On July 25, 1980, the House Judiciary Committee further amended the bill and reported the bill to the full House. On September 22, 1980, S. 658 passed the House on suspension calendar. However, the differences between the Senate and House-passed bills were never resolved.

In the 100th Congress, Senator DeConcini introduced legislation to address the special concerns of municipal bankruptcy. S. 1863 was introduced on November 12, 1987. Similar legislation has also been introduced in the House by Representative Edwards from California (H.R. 3845).

On June 10, 1988, the Subcommittee on Courts and Administrative Practice held a hearing on various bankruptcy legislation pending before the subcommittee. Testimony was received on S. 1863 by James W. Perkins and Lawrence P. King. Professor King testified on behalf of the National Bankruptcy Conference. James E. Spiotto also submitted a statement in support of the legislation.

On August 8, 1988, the Subcommittee on Courts and Administrative Practice held a markup and, with a quorum present, ordered the bill reported, with a technical amendment. On August 10, 1988, the full committee considered the legislation and ordered the bill, as amended, reported to the full Senate.

This legislation is supported by the National Governor's Association, the National Conference of State Legislatures, the National League of Cities, the National Association of Counties, the U.S. Conference of Mayors, the Government Finance Officers Association, the National Association of State Budget Officers, the National Association of Bond Lawyers, the American Public Power Association and the National Bankruptcy Conference.

III. Discussion

EXISTING LEGISLATION

The Enactment of the Current Chapter 9

Current provisions regarding municipal bankruptcy find their origin in the 1970's. Having observed the deficiencies of the old Chapter IX in practice, 60 Stat. 409 (1946), especially with regard to New York City's problems in 1975, an attempt was made to create a mechanism to be responsive to the financial troubles of a municipality. On April 8, 1976, the bill amending Chapter IX of the Bankruptcy Act was signed into law, Public Law No. 94-260 (hereinafter referred to as "1976 legislation"). 90 Stat. 315 (1976). Among the major changes was the elimination of the previous requirement that the municipality obtain the pre-petition consent of 51 percent of its creditors. The 1976 legislation allowed the city to file for bankruptcy without the approval of its creditors and permitted the city to continue borrowing for essential government services. The provisions regarding municipal bankruptcy were further modified in the Bankruptcy Reform Act of 1978 (hereinafter referred to as the "Bankruptcy Code"), 11 U.S.C. Section 101 *et. seq,* whereby Chapter IX was redesignated Chapter 9. The 1978 revision largely adopted the decisions made in 1976 and incorporated by reference most of the business bankruptcy amendments made in 1978 insofar as they related to general matters such as treatment of secured claims, avoiding powers and plans of reorganization. Because the worlds of commercial finance and municipal finance are so diverse, the simple incorporation by reference of the 1978 commercial finance concepts into the municipal bankruptcy arena simply did not work. Chapter 9 was amended slightly by the enactment of the Bankruptcy Amendments and Federal Judgeship Act of 1984 (hereinafter referred to as "1984 Act"). Public Law No. 98-353. However, since 1978, practitioners of municipal law have recognized that steps needed to be taken to clarify unintended conflicts between municipal law and the Bankruptcy Code.

The Bankruptcy Code was enacted to reflect the vast changes in commercial law that had occurred in the 40 year period since bankruptcy law was last revised. At that time, Chapter 9 generally was amended to apply commercial bankruptcy law concepts to municipal corporations. However, due to the different nature of the evolution of municipal finance, some of the specific effects of the sweep-

ing application of commercial law concepts to municipal corporations have raised serious concerns by municipalities. Those efforts were not entirely successful because the resulting application of commercial law concepts to municipal corporations runs afoul of the traditional structure of revenue bond finance.

The potential problems created by the incorporation of general commercial finance concepts into the municipal bankruptcy provisions first came to light as a result of the financial crisis confronting the city of Cleveland, Ohio, in 1979. Cleveland needed additional financing, but lenders were unwilling to lend for a variety of reasons, including the incorporation into Chapter 9 of the general Bankruptcy concept of section 552 of the Bankruptcy Code. Under Section 552, a lien on after-acquired property will not attach to property acquired after bankruptcy by a reorganizing debtor unless the property acquired after bankruptcy constitutes proceeds of property held at the time of the bankruptcy. Thus, the lenders who contemplated providing financing during the financial troubles of the city were discouraged given the concern that their security interests might terminate upon a Chapter 9 filing by the city.

While Chapter 9, therefore, may be viewed as an option by special tax districts and other small special purpose municipal corporations, a review of the entities filing Chapter 9 since the effective date of the Bankruptcy Code reveals that the Chapter has not been widely used. (See Appendix A following the text of the Report for a listing of 32 Chapter 9 Bankruptcies filed under Chapter 9 of the Bankruptcy Code.) Clearly, much of this reluctance is due to the uncertainty of the effect of Chapter 9 on municipal debt.

Such uncertainty may have dire effects in the future. The relevant data suggest that there will be a number of cities, especially small and medium sized cities, which may suffer significant budget deficits due to anticipated interest rate increases in 1989. These are the cities which most likely will need continued municipal finance, especially for necessary improvements or maintenance to infrastructure. At the same time, however, there will be increasing concern in the municipal bond market that if such cities seek any relief under Chapter 9 of the Bankruptcy Code, and Senate bill 1863 has not been enacted, then termination of the pledge of revenues under Section 552(a) of the Bankruptcy Code may result. Another issue regarding a financially troubled municipality will involve the extention of any credit by the municipal bond market during the 90-day period prior to a Chapter 9 filing. Any such pledge or payment of the bonds could be deemed a voidable preference under Section 547 of the Bankruptcy Code.

The current difficulties with the Bankruptcy Code are most readily apparent when analyzing the potential consequences to revenue bond financing. This is an area of great concern to municipalities. The total volume of municipal bonds issued in 1987 was $93,953,905,000, of which $58,979,319,470 were revenue bonds. Revenue bonds are issued to finance projects or programs, and the revenues from such a project or program are pledged to repay the bonds—for example, toll roads, water systems, sports and convention centers, health care facilities, sewer and waste water treatment facilities, power generating facilities, waste disposal facilities, or low and moderate income housing programs. In contrast, gener-

al obligation ("GO") bonds are bonds for which the general taxing power of the issuer is pledged to repay the bonds. Usually, GO bonds are issued to finance capital projects such as transit systems or roads, but also can be used to finance budget deficits and annual governmental expenses. With the GO bond, the general taxpayers are in essence committed to raise their future taxes to whatever level may be necessary to repay the bondholders.

At the same time the municipality approves financing through a revenue bond project or program, however, it has made the assumption that the project or program will generate adequate revenues to repay the bondholders and operate the project or program without any general financial obligation on the part of the municipality. Thus, unlike GO bonds, the general taxpayers are usually not committed to repaying the bonds or funding operational deficits through general tax revenues. Hence, it would be quite problematic and contrary to state law if a bankruptcy filing resulted in revenue bonds being converted into GO bonds. Yet that is a potential consequence under current law.

EXPLANATION OF MAJOR AREAS OF CONCERN REGARDING EXISTING LEGISLATION

Pledged Revenues

Revenues bonds generally are secured by revenues dervied from the project or by a specific tax levy because applicable municipal law generally prohibits the encumbrance of municipal property with mortgates. Under Section 552 of the Bankruptcy Code, now applicable to Chapter 9 under Section 901, a lien terminates upon bankruptcy as to property acquired after the filing of a petition except for "proceeds, product, * * * etc." of property already subject to the lien. 11 U.S.C. Section 552(b). Section 552(b) invalidates the reach of after-acquired property clauses to property acquired by the debtor after the filing of the petition regardless of the validity of the lien under state law. The only exception is for "proceeds", a term that is largely undefined by the Bankruptcy Code or case law. (Most cases defining the term follow its use in the Uniform Commercial Code). Thus, Section 552(b) may be interpreted to defease the lien on revenues assigned by the debtor to secure bonds unless the revenues collected after the filing of the petition can be traced as proceeds of some other property of the debtor which was subject to a lien prior to the filing, such revenues are not subject to a lien in favor of the bondholders.

If the municipality files for bankruptcy, therefore, Section 552(b) may permit general creditors of the municipality to seek payment from the pledged revenues and prohibit the specified payment of pledged revenues to the bondholders. Such an interpretation would effectively destroy the distinction between general obligation debt and limited revenue obligation debt. Accordingly, there is a real concern that revenues dedicated to the repayment of municipal and local obligations will be diverted to other purposes once a municipality or local government enter bankruptcy. (See the district court decision In re *Badger Mountain Irrigation District, Secured Bondholder Committee* v. *Badger Mountain Irrigation District,* U.S District Court, Eastern District of Washington, No. C-87-161-RSM,

where the Court found that the holders had no right to assess in the future lands within the district for payment of the bonds.)

It may be argued, however, that Section 552(a) is unconstitutional to the extent that it invalidates a lien created by an act of a state or municipal legislature. *See Ashton* v. *Cameron County Water Improvement District No. 1,* 298 U.S. 513, 80 L.Ed. 1390, 56 S.Ct. 892 (1936); and *U.S.* v. *Berkins,* 304 U.S. 27, 82 L.Ed. 1137, 58 S.Ct 811 (1938), where the Supreme Court addressed the relationship between federal bankruptcy legislation and the state's sovereignty concluding that federal bankruptcy legislation could not infringe with the government and affairs of municipalities.

It can also be argued that the right to receive revenues is "property." If the trust indenture or bond resolution specifies that the lien extends to "proceeds" of such property, it can be argued that the revenues are proceeds of that property. Perhaps one could distinguish those revenues which are collected after the filing, but which are proceeds of tax assessments or levies made before the filing, from those which are assessed, levied and collected after filing. The right to collect an assessed tax, where the only matter remaining outstanding is the collection of the revenue, would seem to be "property"and the subsequent revenue woud be "proceeds" thereof. [This is analogous to accounts receivable, where checks received by a debtor in collection of accounts receivable are considered to be proceeds of the preexisting accounts under the Uniform Commercial Code and accordingly are subject to the prepetition lien].

The application of Section 552 in a Chapter 9 bankruptcy proceeding may also defy practical reality and state law mandates. As in the case of the San Jose School District, *In re San Jose Unified School District, No. 5-83-02387-A-9,* (B.C.N.D. Cal. 1983), the continued payment of interest to bondholders not only helped ensure the debtor's continued access to credit markets but also helps fulfill the requirement of state law that such collected funds be used to pay bondholders. Cal. Educ. Code Ann. 15251.

Accordingly, as a practical matter, even though Section 552 of the Bankruptcy Code provides that the pledge is terminated, given the mandate of the law and the practical reality of municipal finance, a municipality might well attempt to ignore that provision and continue to pay the bondholders as originally promised. Municipalities, prior to and after the enactment of the Bankruptcy Code, have so acted, such as the San Jose School District and Medley, Florida, *In re City of Medley, Fla., No. B68-236,* (B.C.S.D. Fla. 1968). Such disregard for Section 552 can lead to a problem in obtaining confirmation of a plan of debt adjustment (the vehicle for resolving a Chapter 9 case) given the requirement of compliance with the provisions of the Bankruptcy Code.

In the municipal context, therefore, the simple answer to the Section 552 problem is that Section 904 and the tenth amendment should prohibit the interpretation that pledges of revenues granted pursuant to state statutory or constitutional provision to bondholders can be terminated by the filing of a chapter 9 case. Likewise, under the contract clause of the Constitution (article I, section 10), a municipality cannot claim that a contractual pledge of revenue can be terminated by the filing of a chapter 9 proceeding. *See*

United States Trust Co. v. *New Jersey,* 431 U.S. 1073 (1977); *Davies* v. *Minneapolis,* 316 N.W.2d 498 (Minn., 1982). However, the significant uncertainties created under current law make clarification of the law necessary.

Payments of Interest and to Retire Bonds as Preferences

It may be argued that a lien on revenues collected by a municipality during the 90 days prior to the filing of a petition in bankruptcy purusant to chapter 9 is a voidable preferential transfer. Section 547(e)(3) of the Bankruptcy Code, which is applicable to Chapter 9 under 11 U.S.C. Section 901, provides that a transfer (including transfer of a security interest) is not made until the debtor has rights in the property. A debtor may arguably not acquire rights in revenues until the tax or assessment is levied or the service from which the revenue is derived is provided. Under this view, to the extent that the pledge of such revenues would give a creditor more than he would otherwise receive in a liquidation of the municipality, the attempt to create a security interest therein would constitute a voidable preference. Thus, Section 547(e)(3) may have the effect of making the date of termination of preexisting liens on revenues a date ninety days prior to the filing of a Chapter 9 petition rather than as of the date of the filing. In certain instances, this would result in demands for repayment of principal and interest received by revenue bondholders during the ninety day period. How such money is to be collected from the holders of a widely held issue is not clear.

There are, however, certain exceptions in the preference statute. Pledged municipal revenues may fall within the exception to voidable preferences relating to exchanges for new value. 11 U.S.C. § 547. See § 9-306 of Uniform Commercial Code. Another view is that the pledged municipal revenues constitute "receivables" and hence only a partial preference results, to the extent of any net reduction in the excess of the secured claim over the value of the security. Section 547(e)(3) of the Bankruptcy Code defines a receivable as "a right to payment, whether or not such right has been earned by performance." (This definition is broader than that of the Uniform Commercial Code for "accounts"). Also, in the municipal finance context, if the lien on future revenues is voided as a preference, the result is at odds with public policy and state enabling legislation which almost invariably provides that pledges of such revenues are effective when made and good against other creditors.

If proceeds of a new bond issue (*i.e.,* a "refunding issue") acquired during the preference period are specifically designated by the terms of the issue to be used to defease a prior indenture (predating the preference period) then probably no preference problems are presented. Generally, new unsecured loans or payments to creditors by a third party are not transfers of debtor's property. If the property is never in the debtor's estate but goes directly from a third party to creditor, the estate of debtor is not diminished. If the debtor gives new security for the refunding bond issue, then it may be argued that there is a diminution of the estate and there is a preferential transfer to the extent of the collateral's value. *See Virginia Nat. Bank* v. *Woodson,* 329 F.2d 836 (4th Cir. 1964); *Steel*

Structures, Inc. v. *Star Mfg. Co.*, 466 F.2d 207, 217 (6th Cir. 1972); *Grubb* v. *General Contract Purchasing Corp.*, 94 F.2d 70, 72 (2d Cir. 1938); *National Bank of Newport* v. *National Kerkimer County Bank*, 225 U.S. 178 (1912).

Similarly, use of funds deposited in a debt service reserve fund or with a indenture trustee prior to the preference period and paid out to bondholders during the preference period probably is not a voidable preference. The "transfer" occurred before the preference period, and the debtor's estate was not diminished. No additional security was given. Also, a payment into a debt reserve fund during such preference period may be argued not to be a preference if funds were previously pledged and collected prior to the preference period.

Troubled municipalities which desperately need additional financing may experience the reluctance of the market to purchase its revenue bond securities because under the Bankruptcy Code a refunding issue or payment of interest might be interpreted as a preference or the payment of pledged revenues within the 90-day period might be deemed under section 547 to be a preference.

Transformation of Revenue Bond Issue Into General Obligation

The Bankruptcy Code can be interpreted as changing the very essence of certain municipal obligations upon the filing of a Chapter 9 proceeding. Section 1111(b) can be interpreted as converting revenue bondholders from creditors with rights to certain specific revenues into general creditors with a claim against the full faith and credit of the municipality. For example, if a pledge of future revenues is defeated by Sections 547(e)(3) and 552 of the Bankruptcy Code as a preference or as an impermissible post-petition lien, or if a municipality seeks to use property of the estate which is secured by a lien on revenues which is without recourse to the municipality, as would be the case in a revenue bond issue, the revenue bonds may be transformed into, in effect, a recourse claim changing a revenue bond issue into a general obligation of the debtor. If Chapter 9 were interpreted in this way, the burden of bonds designed to be paid only from special revenues could be imposed on taxpayers generally through taxation, despite the fact that the bonds might thereby exceed the municipality's debt limit or would have required a vote if originally issued as general obligation bonds.

Similarly, a municipality often has enterprise with separate funds, and except to the extent specifically permitted, the funds derived from one source are often legally unavailable for other enterprises or for general governmental purposes. Thus, for example, water receipts may be legally unavailable under nonbankruptcy law for general governmental purposes except to the extent that provision is made by law for payments by the water department in lieu of local property taxes. Although the various enterprises are not separate entities, they are operated almost as if they were. In many cases, they are managed by separate autonomous governing boards. If a municipality is unable to meet its obligations for general governmental purposes, and for that reason files a bankruptcy petition, the assets of its water department should not be reached to pay general creditors of the municipality unless they could be

reached under applicable nonbankruptcy law. Conversely, if water revenues are insufficient to pay operating expenses and the debt service on water revenue bonds, other funds of the city should not be reachable to pay the bonds. In many cases, it would violate state constitutional limitations to do so. Similarly, insolvency in the water department should not trigger preference treatment of payments made to general fund creditors, or vise versa.

The Bankruptcy Code creates an apparent risk that revneue bonds can be converted into general obligation bonds. A partially secured bondholder (i.e., one whose lien on revenues is insufficient to pay his bonds), if he does not have recourse against the debtor for the remainder of his claim under nonbankruptcy law, will be treated as if he did have recourse.

Under Section 1111(b) of the Bankruptcy Code, the bondholders may elect as a class either to continue to have their entire claim treated as secured by the revenues or as any deficiency claim satisfied by recourse to the general assets of the municipal debtor. An election to continue to be secured by revenues cannot be made if the collateral revenues pledged or held are "sold" or to be sold under a plan. Even revenue bonds arguably may be treated by the holders as providing "recourse" against the debtor because of the state law liability of the debtor for pledging future revenues. Even if the bonds are treated as nonrecourse, where the revenues are "sold", the separate unsecured portion pursuant to the plan would be an allowable recourse claim. *See First Nat. Bank of Colorado Springs* v. *Hamilton*, 8 BCD 1116, 18 BR 868, 6 CBC 2d 482 (D. Colo. 1982); *In re Whitaker*, 8 BCD 1187, 18 BR 314, 6 CBC 2d 205 (D. Kan. 1982).

Moreover, even if a nonrecourse claim is converted into a recourse claim under Section 1111(b), the question is posed whether the revenue issue is transformed, in effect, into a general obligation of the municipal body contrary to the state constitutional or statutory debt limitation. The problem is created by using private corporate debt principles and applying them in a municipal financing context. While nonrecourse financing is a method of "off balance sheet" corporate financing with a lien against certain assets so that if the assets are sold or the lien terminated by bankruptcy, the resulting election of recourse or nonrecourse actually preserves the benefit of the bargain payment for the debt. However, in the municipal context, the benefit of the bargain is solely the revenues from the project and never the full faith and credit of the municipality. This essential difference and balancing of risk demonstrates the different perspectives regarding the application of Section 1111(b) to a private corporation financing as compared to a municipal financing. Further, the effect of the application of Section 1111(b) to municipal financing is prohibited by Section 904; the transformation of revenue bond (nonrecourse) financing into general obligation bond (recourse) financing permits municipalities to violate state statutory and constitutional provisions which in many cases prohibit such recourse debt (general obligation bonds) above a certain percentage of assessed value or other limits without voter approval.

The Definition of Insolvency

A municipality is presumed to be insolvent during 90 days perior to the commencement of the case. [Section 547(f) of the Bankruptcy Code]. However, the test of insolvency is questionable if insolvency means that debt exceeds non-exempt assets. [Section 101(26)(A) of the Bankruptcy Code]. Many municipalities may be termed "insolvent" if assets exempt from attachment by state law are excluded. By the nature of municipalities and generally by state law, most of the assets of a municipality are exempt from process to satisfy the claims of creditors. As such virtually every municipality, by definition is insolvent. Because a municipality's assets cannot be seized or sold to pay debts, or are so tailored to a specific purpose that their value is uncertain at best, the value of city hall should make little difference to creditors. A more reasonable test would be whether the municipality is paying or is able to pay its debts as they become due, which is the alternative standard for filing a municipal bankruptcy petition under Section 109(c)(3) and the test for an involuntary bankruptcy against a nonmunicipal debtor contained in Section 303(h)(1).

Treatment of Lease Obligation in Conduit Financing

A number of states have passed statutes authorizing the use of municipal building authorities which for set periods of time lease buildings to the local governmental bodies, such as the city hall, court buildings, police and fire stations and jails. The building authorities are financed generally by issuing revenue bonds secured by the building and sometimes only by the revenue of the lease. See e.g., *Municipal Building Authority of Iron County, Utah,* v. *Lowden,* 711 P.2d 273 (Utah 1985).

Under Section 502(b)(6) of the Bankruptcy Code, a claim arising out of the termination of a lease of real estate is limited to the rent reserved by such lease, without acceleration, for the greater of 1 year or 15 percent not to exceed 3 years of the remaining term of such lease following the earlier of (i) the date the petition was filed instituting the action or (ii) the date on which such lessor repossessed or the lessee surrendered the leased property plus any unpaid rent due under such lease without acceleration as of the earlier of such dates. However, the lease by the municipal building authority, as was noted in the legislative history surrounding Chapter 9 of the Bankruptcy Code regarding conduit financing, should be considered a "financing lease" and not a lease of real estate. S. Rep. No. 95-989, 95th Cong., 2d Sess., 64, *reprinted in* [1978] U.S. Code Cong. and Ad. News 5787, 5850.

In addition, the 1984 Bankruptcy Amendments added Section 365(m) which provides "leases of real property shall include any rental agreement to use real property." Section 365(d)(4) requires the assumption or rejetion of nonresidential real property leases within 60 days of the date of the order of relief. If a municipal building authority lease which secures a revenue bond financing is treated as a nonresidential real property lease, undue burdens are placed on the municipality and the municipal building authority contrary to state law. State law generally provides that if the municipality does not appropriate the rent, the lease may be terminat-

ed. Section 365(d)(4) may interfere with that state law decision process. In addition, for municipal finance purposes, such leases are treated as debt for tax purposes and sold as debt in the tax exempt bond market.

Automatic Stay

The automatic stay of Bankruptcy Code Section 362 is extremely broad, preventing any post-petition collection activities against the debtor, including application of the debtor's funds held by a secured lender to secure indebtedness. This provision is overly broad in Chapter 9, requiring the delay and expense arising from a request for relief from the automatic stay to accomplish what many state statutues mandate: the application of pledged revenues after payment of operating expenses to the payment of secured bonds. The automatic stay should specifically be inapplicable to application of such revenues. The Bankruptcy Court could retain the power to enjoin application of proceeds, however, upon a specific showing of need, for example, where a secured creditor was about to apply proceeds of a gross revenue pledge in a matter inconsistent with policies of the proposed new section.

Change In Rates

In a corporate reorganization, a change in the debtor's rates is subject to rate regulation. Code Section 1129(a)(6). Municipal utilities in a number of states are subject to rate regulation, and the same provision should apply to them as to private corporations. Municipal systems are often also subject to other regulatory requirements and to political requirements, unique to governments, such as voter approval of additional debt. Some have expressed a concern that a failure to make a plan subject to requirements of this sort could override state and local financial and political controls and raise constitutional issues as to the scope of the bankruptcy power that need not be resolved to further sound municipal bankruptcy policy.

Adequate Protection

Sections 362 and 364 require adequate protection to secured creditors in order to continue an automatic stay or to permit a priority borrowing. These provisions apply to all bankruptcies. If the "adequate protection" in fact proves to be inadequate, the secured creditor has a super priority claim under Section 507(b). Under the present Bankruptcy Code, this applies only to individual and corporate bankruptcies and not to municipal bankruptcies. There is no reason for such a distinction.

Since Chapter 9 is not a vehicle for elimination of debt but rather for debt adjustment, liquidation is not permissible, and since all priority claims must be paid as a condition of plan confirmation, the ranking of various types of administrative expenses in a priority or super priority order may not add anything to the statute. However there should not be any doubt that a failure of adequate protection should give rise to an administrative expenses claim. An amendment to resolve any doubt is warranted.

Use of United States Trustees in Chapter 9 Cases

Section 901 incorporates by reference all of Section 1102, which provides for the appointment of creditors' committees. Section 1102(a) provides that the U.S. Trustee shall appoint the committee members. Because Chapter 9 does not provide for involvement of the U.S. Trustee in the administration of municipal bankruptcies, in Chapter 9 cases, the court will be responsible for the appointment of members of creditor committees.

SUMMARY OF SIGNIFICANT AMENDMENTS

The legislation recognizes a post-petition security interest in revenue under certain specified circumstances, more fully described below. And it makes the preference section inapplicable to payments on bonds or notes of a municipality. The former change corrects the problem posed by Section 552. It also makes it more difficult if not impossible for a municipal debtor to utilize the preference section to recover payments to bondholders made from pledged revenues within 90 days before bankruptcy because it will be more difficult to prove the more than liquidation test of Section 547(b)(5).

The amendments protect the future effectiveness of revenue bond financing against the possibility of an adverse judicial determination in connection with a municipal bankruptcy. Specifically, the amendments insure that in the event of a municipal bankruptcy, taxpayers will not be required to pay bondholders for bankrupt municipal projects that were intended to be funded exclusively through project revenues. The amendments insure that state constitutional and statutory debt limits will not be preempted by the application of bankruptcy laws. Finally, the amendments insure that revenue bondholders receive the benefit of their bargain with the municipal issuer, namely, they will have unimpaired rights to the project revenue pledged to them.

Elimination of Applicability of Section 552 to Chapter 9 Case

Section 552 of the Bankruptcy Code is currently made applicable to a Chapter 9 case by reference in Section 901(a) of the Bankruptcy Code. Various questions have been raised that a pledge of municipal revenue and the lien created thereby will be terminated in a municipal bankruptcy due to the application of Section 552(a) to Chapter 9. To eliminate the confusion and to confirm various state laws and constitutional provisions regarding the rights of bondholders to receive the revenues pledged to them in payment of debt obligations of a municipality, a new section is provided in the amendments to ensure that revenue bondholders receive the benefit of their bargain with the municipal issuer and that they will have unimpaired rights to the project revenues pledged to them.

New Section 927, along with the definition of special revenues in Section 902(3), protects the lien on revenues. It is closely modeled on Section 552(a). It is intended to negate Section 552(a) in the municipal context and to go no further. In other words, it is not intended to create new rights that otherwise would not exist under state law and constitutional provisions. Section 552(a) limits preexisting rights. The proposed amendment only removes that limita-

tion in the circumstances described in proposed Section 927(a). The proposed amendment applies only to special revenues as defined in proposed Section 902(3). Examples of the kinds of revenues included within the definition are revenues from municipally owned utility systems, betterment assessments, special excise taxes and fees, and in some instances local sales, income or property taxes. Utility revenues include revenues from the sale of water power, natural gas, or other energy sources. It also includes revenues from a toll, highway or bridge or other projects or systems which impose user fees. Hotel/motel taxes, meal taxes and license fees are included in special excise taxes. They are often imposed for a particular purpose. For example, a hotel/motel excise or meal tax might be imposed throughout a city to finance the construction and operation of a convention center. Tax increment financing will also receive the benefit of the proposed amendment. A city may finance street, utility and land assembly costs for a downtown renewal project on a tax increment basis. That is, the bonds issued to pay for the project are payable solely from and are secured by a lien on the additional tax resulting from the increased valuations in the project area. Project financing can also create special revenues. A municipality may attempt to finance separate projects by liens on the revenue of each project, issuing separate bonds for each project. Prior to and during the construction of the project, the proceeds from the project financing as well as receipts received in connection with the project financing and funds held in the special accounts under the terms of the indenture or bond resolution would be special revenues. Project revenues, whether based on the sale of goods or services or based on cost sharing among users, would constitute special revenues. The amendment amounts to a recognition of a hypothetical mortgage from which revenues are derived where a real mortgage cannot be created either for legal reasons or because of compelling considerations of public policy.

Clarification of the Applicability of Section 547 and Lifting of Automatic Stay

In order to clarify that payment of a bond or note is not a preferential transfer under Section 547 of the Bankruptcy Code if such is made within 90 days of the filing of the Bankruptcy Petition, a new section is added to specifically so state. Likewise, the automatic stay that becomes effective against creditors of a municipality is made inapplicable to the payment of principal and interest on municipal bonds paid from pledged revenues. In this context, "pledged revenues" includes funds in the possession of the bond trustee as well as other pledged revenues.

Transformation of Revenue Bond Issue Into General Obligation

In order to avoid use by a municipality in a Chapter 9 proceeding of revenues pledged pursuant to a revenue bond issue, thereby allowing the relevant bondholders to transform that revenue bond issue (liability limited to project revenues) into a general obligation (full faith and credit of Municipality) under the terms of Section 1111(b) of the Bankruptcy Code, Section 925 is amended by adding a new subsection (b) to specifically articulate that the holder of

such a revenue bond claim shall not be treated as having recourse against the debtor under Section 1111(b).

SCOPE OF THE APPLICABILITY OF THE AMENDMENTS

Under longstanding principles, the municipal bankruptcy amendments should apply to any bankruptcy cases pending upon or commenced after the effective date of the amendments. A discussion of the basic rules governing application of the amendatory provisions of the statutes was articulated by the U.S. Supreme Court in *Bradley* v. *School Board of the City of Richmond,* 416 U.S. 696, 711, 94 S.Ct. 2006, 2016, L.Ed. 2d 476 (1974): "We anchor our holding in this case on the principal that a court is to apply the law in effect at the time it renders its decision, unless doing so would result in manifest injustice or there is a statutory direction or legislative history to the contrary." The origin and the justification for this rule are found in the words of Mr. Chief Justice Marshall in *United States* v. *Schooner Peggy,* [5 U.S.] 1 Cranch 103 [2 L.Ed. 49] (1801): "It is in the general true that province of an appellate court is only to inquire whether a judgment when rendered was erroneous or not. But if subsequent to the judgment and before the decision of the appellate court, a law intervenes and positively changes the rule which governs, the law must be obeyed or its obligation denied. If the law be constitutional * * * I know of no court which can contest its obligation."

The rule of *United States* v. *Schooner Peggy* was clarified in *Thorpe* v. *Housing Authority of the City of Durham,* 393 U.S. 268, 89 S.Ct. 518, 21 L.Ed. 2d 474 (1969), where the Supreme Court ruled that a court must apply the law in effect at the time it renders its decision, noting that the *Schooner Peggy* reasoning had been applied whether the change was constitutional, statutory or judicial. This principal was utilized in a case involving a bankruptcy statute in *Carpenter* v. *Wabash Railway Company,* 309 U.S. 23, 60 S.Ct. 416, 84 L.Ed. 558 (1940) (amendment to bankruptcy statute enacted while case pending for review held applicable).

The *Schooner Peggy* doctrine has recently been applied to amendments to the Bankruptcy Code which were effective August 13, 1981, which held that certain child support obligations were nondischargeable. The first court to face the issue held that the amendments were applicable to pending cases on the reasoning on the *Schooner Peggy* case. *In re: Kuehndorf,* 24 B.R. 555 (W.Dist. Wis. 1982). Further, such position was adopted by the United States Court of Appeals for the Ninth Circuit in *Matter of Reynolds,* 726 F.2d 1420 (9th Cir. 1984).

Another rule may be applicable where legislation may be held to abrogate vested property rights. (*See, e.g., Halt* v. *Henley,* 232 U.S. 637, 34 S.Ct. 459, 58 L.Ed. 767 (1914); *Union Pacific Railway Company* v. *Laramie Stockyards Company,* 23 U.S. 190, 34 S.Ct. 101, 58 L.Ed. 179 (1913); *Auffm'ordt* v. *Rosin,* 102 U.S. 620, 26 L.Ed. 262 (1881); *United States* v. *Security Industrial Bank,* 459 U.S. 70, 103 S.Ct. 407, 74 L.Ed. 2d 235 91982). In such situations, subsequent statutes may not act to interfere with fixed property interests. However, the amendments only severe to clarify long standing principles and in fact preserve rather than abrogate existing

rights. Therefore, there is no reason to depart from the general rule that the amendments should apply to all pending cases on the effective date.

The application of the amendments to cases pending as of the effective date is not a critical issue because the amendments clarify the Bankruptcy Code to eliminate conflicts with state municipal law provisions and practices. If the amendments are not applicable to pending Chapter 9 cases of the effective date, the Bankruptcy Court should reason to the same result given the clarification contained in the amendments. If the amendments are made applicable, the effect is only to a handful of Chapter 9 cases pending for small municipal bodies.

APPENDIX A.—CHAPTER NINE CASES FILED JUNE 1988

Year:	Court debtor	Docket district	Number	Plan of reorganization	Confirmation of plan
1986	(D) Cooper River School District	Alaska	3–86–00820	Feb. 17, 1988	
1983	(B) South Tucson, AZ	Arizona	83–00866	Dec. 23, 1983, Feb. 21, 1984 amendment; Apr. 5, 1984 amendment.	Apr. 9, 1984 confirmation; case closed Mar. 23, 1988.
1986	(D) Lassen Community College District	California	2–86–01379	No plan filed	
1987	(A) Eagles Nest Metropolitan District	Colorado	87B1512E	Written request for date; awaiting response	
1984	(A) Whitley County Water District	Eastern Kentucky	84–00089	No plan filed	Case dismissed Apr. 17, 1985.
1982	(B) Wapanucka, OK	Eastern Oklahoma	82–00231	No plan filed; case dismissed Oct. 14, 1983	
1987	(A) Lake Grady Road and Bridge District, Hillsborough County, FL.	Florida	87–1590	Aug. 31, 1987	Jan. 15, 1988.
1987	(A) Water & Sewer District "A" Pasco County, FL.	Florida	87–3218	Mar. 4, 1987	July 20, 1987.
1985	(A) Bell County Garbage and Refuse Disposal District.	Kentucky	85–143	May 8, 1988	No date; case dismissed June 30, 1988.
1982	(A) Pleasant View Utility District of Cheatham County, TN.	Middle Tennessee	82–01139	Apr. 12, 1987, Dec. 22, 1982 (refiled)	Case dismissed May 19, 1983.
1987	(B) Village of Merrill, MI	Michigan	87–09455	June 19, 1987	Case dismissed Dec. 9, 1987.
1987	(B) City of Mound Bayou, MS	Mississippi	87–00295–BKC–DNI	Settled prior to filing plan	
1984	(C) Pulaski Memorial Hospital	Missouri	84–00082	Aug. 14, 1985	Oct. 10, 1985 confirmation; Case closed Jan. 8, 1988.
1984	(B) Wellston City, MO	Missouri	84–01492	Feb. 19, 1984, Jan. 3, 1986 amendment	Plan not confirmed; Case closed Oct. 1, 1986.
1985	(C) Monterey County Special Health Care Authority.	Northern California	85–00649	Jan. 8, 1986	March. 27, 1986
1983	(D) San Jose School District	Northern California	83–02387	Feb. 7, 1984	Case dismissed May 8, 1984.
1981	(D) The Management Institute of San Leandro	Northern California	81–02265	Written request for date; awaiting response	
1983	(C) Jersey City Medical Center	Northern Jersey	83–00829	Mar. 29, 1985	Aug. 6, 1985.
1982	(A) Sanitary & Improvement District No. 5 of Cass County, NE.	Nebraska	82–01671	Nov. 1, 1983; Oct. 24, 1986 amendment; Nov. 12, 1986 amendment; Jan. 22, 1987 amendment.	Feb. 26, 1987.
1983	(A) Sanitary & Improvement District No. 4 of Lancaster County, NE.	Nebraska	83–01456	Oct. 6, 1983; Apr. 17, 1984 amendment; June 18, 1984.	
1983	(A) Sanitary & Improvement District No. 42 of Sarpy County, NE.	Nebraska	83–00956	June 2, 1983; amendment July 27, 1984	Sept. 26, 1984.

1984	(A) Sanitary & Improvement District No. 63 of Sarpy County, NE.	Nebraska	84–01263	June 29, 1984	Mar. 11, 1985.
1985	(A) Sanitary and Improvement District No. 265 of Douglas County, NE.	Nebraska	85–2384	Dec. 27, 1985; Jan. 24, 1986 amendment; July 10, 1986 amendment.	Oct. 7, 1986.
1985	(A) Sanitary & Improvement District No. 7 of Lancaster County, NE.	Nebraska	85–0039	Jan. 15, 1986; Nov. 18, 1986 amendment; May 2, 1988 amendment.	Not yet confirmed.
1986	(A) Sanitary and Improvement District No. 187 of Douglas County, NE Nebraska.		86–1798	June 20, 1986	Nov. 17, 1986.
1986	(A) Sanitary and Improvement District No. 229 of Douglas County, NE.	Nebraska	86–1885	June 27, 1986, Oct. 30, 1986 amendment	Nov. 7, 1986.
1988	(B) Borough of Shenandoah	Pennsylvania	88–20603	Case dismissed prior to filing plan	
1987	(A) Northwest Harris County Municipal Utility District No. 19.	Southern Texas	87–02498–H–2–9	Mar. 10, 1987	
1980	(A) Grimes County Municipal Utility District No. 1	Southern Texas	80–010948	Aug. 19, 1980	Apr. 20, 1981.
1988	(C) South Eastland County Hospital District d/b/a Blackwell Hospital.	Texas	18810005	July 7, 1988	Disclosure hearing set for Aug. 9, 1988.
1981	(A) North and South Shenango Joint Municipal Authority.	Western Pennsylvania	81–00408	Case dismissed May 26, 1982	No plan filed.
1985	(A) Badger Mountain Irrigation District	Washington	03136–299	Nov. 23, 1987	

A = Municipal Utilities; B = City, Village or Country; C = Hospital/Health Care; D = School/Education.

IV. Vote of Committee

On August 10, 1988, with a quorum present, by unanimous consent, the Committee on the Judiciary ordered the bill, as amended, reported.

V. Text of S. 1863

[100th Cong., 1st Sess.]

A BILL To amend the bankruptcy law to provide for special revenue bonds, and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 109(c)(3) of title 11, United States Code, is amended by striking out "or unable to meet such entity's debts as such debts mature".

Sec. 2. Section 901(a) of title 11, United States Code, is amended by inserting "1129(a)(6)," between "1129(a)(3)," and "1129(a)(8)".

Sec. 3. Section 902 of title 11, United States Code, is amended by—

(1) redesignating paragraphs (2), (3), and (4) as paragraphs (4), (5), and (6), respectively;

(2) redesignating paragraph (1) as paragraph (2);

(3) inserting before paragraph (1), as redesignated herein, a new paragraph (1), as follows:

"(1) 'insolvent', notwithstanding section 101(31) of this title, when used in a section that is made applicable in a case under this chapter by section 103(e) or 901 of this title, means financial condition such that the municipality is generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute, or is unable to pay its debts as they become due;"; and

(4) inserting between paragraph (2) and paragraph (4), as redesignated herein, the following:

"(3) 'special revenues' means—

"(A) receipts derived from the ownership, operation, or disposition of projects or systems of the debtor that are primarily used or intended to be used primarily to provide transportation, utility, or other services, including the proceeds of borrowings to finance the projects or systems,

"(B) special excise taxes imposed on particular activities or transactions,

"(C) incremental tax receipts from the benefited area in the case of tax-increment financing,

"(D) other revenues or receipts derived from particular functions of the debtor, whether or not the debtor has other functions, and

"(E) taxes specifically levied to finance one or more projects or systems, but not including (except for tax-increment financing) receipts from general property, sales, or income taxes levied to finance the general purposes of the debtor.".

Sec. 4. Section 922 of title 11, United States Code, is amended by adding at the end thereof the following:

"(c) If the debtor, under this section, or section 362 or 364 of this title, provides adequate protection of the interest of the holder or a claim secured by a lien on property of the debtor and if, notwithstanding such protection such creditor has a claim arising from the stay of action against such property under this section or section 362 of this title or from the granting of a lien under section 364(d) of this title, then such claim shall be allowable as an administrative expense under section 503(b) of this title.

"(d) Notwithstanding section 362 of this title and subsection (a) of this section, a petition filed under this chapter does not operate as a stay of application of pledged special revenues in a manner consistent with section 927 of this title to payment of indebtedness secured by such revenues.".

SEC. 5. (a) Section 925 of title 11, United States Code, is amended by—

(1) adding to the section heading the following:

"and certain secured claims";

(2) striking out "A" and inserting in lieu thereof "(a) A"; and

(3) adding at the end thereof the following:

"(b) The holder of a claim payable solely from special revenues of the debtor under applicable nonbankruptcy law shall not be treated as having recourse against the debtor on account of such claim pursuant to section 1111(b) of this title.".

(b) The table of sections for chapter 9 of title 11, United States Code, is amended by adding before the period in the item relating to section 925, "and certain secured claims".

SEC. 6. Section 926 of title 11, United States Code, is amended by—

(1) inserting "(a)" before "If"; and

(2) adding at the end thereof the following:

"(b) A transfer of property of the debtor to or for the benefit of any holder of a bond or note, on account of such bond or note, may not be avoided under section 547 of this title.".

SEC. 7. (a) Section 927 of title 11, United States Code, is redesignated as section 929.

(b) Title 11 of the United States Code is amended by adding between section 926 and section 929, as herein redesignated, the following new sections:

"§ 927. Post petition effect of security interest

"(a) Notwithstanding section 552(a) of this title and subject to subsection (b) of this section, special revenues acquired by the debtor after the commencement of the case remain subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.

"(b) Any such lien on special revenues, other than municipal betterment assessments, derived from a project or system is subject to the necessary operating expenses of such project or system, as the case may be.

"§ 928. Municipal leases

"A lease to a municipality shall not be treated as an executory contract or unexpired lease for the purposes of section 365 or

502(b)(6) of this title solely by reason of its being subject to termination in the event the debtor fails to appropriate rent.".

(c) The table of sections for subchapter II of chapter 9 of title 11, United States Code, is amended by striking out the item relating to section 927 and inserting in lieu thereof the following:

"927. Post petition effect of security interest.
"928. Municipal leases.
"929. Dismissal.".

SEC. 8. Section 943(b) of title 11, United States Code, is amended by—

(1) striking out "and" at the end of paragraph (5);

(2) striking out the period at the end of paragraph (6) and inserting in lieu thereof semicolon;

(3) redesignating paragraph (6) as paragraph (7); and

(4) inserting between paragraph (5) and paragraph (7), the following:

"(6) any regulatory or electoral approval necessary under applicable nonbankruptcy law in order to carry out any provision of the plan has been obtained, or such provision is expressly conditioned on such approval; and".

VI. SECTION-BY-SECTION ANALYSIS

SECTION 1

This amendment and the proposed Section 902(1) should be read together. They make a general failure to pay debts the criterion for municipal insolvency and eligibility for filing. They replace the assets versus liabilities test. The assets versus liabilities test is not meaningful in the case of a municipality given the exemptions frequently granted to municipal property under State law. See the comment on proposed Section 3 below.

SECTION 2

Section 1129(a)(6) should apply to municipalities, as it does to other debtors, since municipal utilities are subject to rate regulation in a number of states. Municipal plans of adjustment should be subject to such regulatory approval, where applicable in the same manner as investor-owned utilities.

SECTION 3

Section 101(31) defines insolvency as debts exceeding the fair value of assets.

Many municipal assets are special-purpose assets and have a highly uncertain market value, which is probably less than cost. Under these circumstances, many healthy municipalities would be treated as "insolvent". Under these circumstances, many healthy municipalities would be treated as "insolvent". Also, by statute, many municipal assets cannot be reached to pay debts, rendering the assets exceed liabilities test somewhat irrelevant to creditors. This amendment uses a more realistic test to determine whether the municipality is insolvent. The change in Section 109(c)(3) (above) is correlative to this change.

The definition of special revenues is needed for the purposes of revised Sections 922, 925 and 927. Examples of the special revenues mentioned in clause (A) include receipts derived from or received in connection with the ownership, financing, operation or disposition of a municipal water, electric system or transportation system.

An excise tax on hotel and motel rooms or the sale of alcoholic beverages would be a special excise tax under clause (B). "Special excise taxes" are taxes specifically identified and pledged in the bond financing documents and are not "generally" available to all creditors under state law. A general state sales tax would not be a special excise tax.

In a typical tax-increment financing referred to in (C), public improvements are financed by bonds payable solely from and secured by a lien on incremental tax receipts resulting from increased valuations in the benefited area. Although these receipts are part of the general tax levy, they are considered to be attributable to the improvements so financed and are not part of the pre-existing tax base of the community.

Examples of revenues from particular functions under clause (D) would include regulatory fees and stamp taxes imposed for the recording of deeds or any identified function and related revenues identified in the municipality's financing documents such as tolls or fees relating to a particular service or benefit.

Under clause (E) an incremental sales or property tax specifically levied to pay indebtedness incurred for a capital improvement and not for the operating expenses or general purposes of the debtor would be considered special revenues. Likewise, any special tax or portion of a general tax specifically levied to pay for a municipal financing shall be treated as special revenues. For this purpose a project or system may or may not be revenue-producing.

SECTION 4

Reasonable assurance of timely payment is essential to the orderly marketing of municipal bonds and notes and continued municipal financing.

Where a pledge of revenues survives under Section 927, it would be needlessly disruptive to financial markets for the effectuation of the pledge to be frustrated by an automatic stay, or unless there is adequate protection and a priority under Section 507(b), by a stay ordered by the court.

Where a pledge of revenues survives under Section 927, it would be needlessly disruptive to financial markets for the effectuation of the pledge to be frustrated by an automatic stay. Further, the use of an automatic stay may be contrary to Section 904 and interfere with the government, affairs and the municipality's use or enjoyment of income producing property.

The super-priority granted by Section 507(b) for a failure of adequate protection currently does not now apply to Chapter 9. Nevertheless, the creditor's loss from the automatic stay or from the granting of a priming borrowing lien should be entitled to administrative expense priority, because the creditor's loss came as a result of an attempt to benefit the post-petition debtor. This amendment makes explicit, therefore, what is implicit in section 507(b).

SECTION 5

Section 1111(b) provides that in some circumstances non-recourse debt may be treated as recourse debt. Many municipal obligations are, by reason of constitutional, statutory or charter provisions, payable solely from special revenues and not the full faith and credit of the municipality. This amendment leaves these legal and contractual limitations intact without otherwise altering the provisions with respect to non-recourse financing. Thus, this section avoids the potential conversion of revenue bonds into General Obligation bonds under Section 1111(b).

SECTION 6

This section makes the preference provisions inapplicable to municipal bond payments and defeasances.

In the case of a municipality it is not considered necessary to legislate broadly against preferential treatment of bond and noteholders. There is not likely to be a high incidence of preferential treatment of these creditors and, where there is an actual intent to hinder, delay or defraud other creditors, Section 548 would apply. The existing law, under which section 547 applies to municipal bonds and notes, creates unforeseen problems and uncertainties. For example, most municipal revenue bonds involve a pledge of special revenues but do not include a mortgage or other security interest on any revenue source. The application of Section 547 to them could cause payments of such bonds in the normal course to be treated as preferences since the lien on revenues received during the preference period could be treated as coming into existence during the preference period and not before. In addition, the deposit of money or securities in escrow to "defease" in the lien of a prior bond indenture, which is a common occurrence, could also be treated as a preference notwithstanding the absence of any preferential intent or actual damage to other creditors. This section is intended to allow municipalities and their holders of notes and bonds to have the same rights under state law and constitutional provisions as to transfers and benefits conferred prior to the institution of a Chapter 9 case.

SECTION 7

This section preserves the lien on special revenues to secure bonds or notes, subject to payment of necessary operating expenses.

If deemed to apply to a Chapter 9 case, Section 552(a) could terminate the security for municipal revenue bonds upon commencement of the case where (as is usually the case), there is no mortgage or security interest on any revenue source. Paragraph (a) of Section 927 makes it clear that such a result is not intended. It permits a lien on special revenues to continue under state law but, under paragraph (b), a lien on project or system revenues would be subordinate to necessary operating expenses of the project or system. Necessary operating expenses are operating expenses which are necessary to keep the project or system going and producing special revenues. Prepetition operating expenses are included to the extent payment is deemed necessary by the court for this purpose.

In the case of a project financing, the lien would be subordinate to the necessary operating expenses of the project. An example of a project financing would be the financing of an electric generating plant by indebtedness secured by a lien on revenues from the sale of output of the particular facility. An example of system financing would be the financing of improvements to a local electric distribution system secured by a lien on revenues of the entire system.

Subsection (b) of Section 927 reflects the fact that betterment assessments are levied to finance the construction costs of sewers, streets, and the like and that the operating costs are financed separately out of current user charges or taxation. In the case of bonds secured by these assessments, subordinating the lien to operating expenses would materially change the bargain. The intent of Subsection (b) is not to change the priority and intent of the use of the special revenues under the terms of the municipal debt financing documents.

Subsection (b) sets forth a minimum standard for paying operating expenses ahead of debt service where revenues are pledged. It is not intended to displace any broader standard contained in the terms of the pledge or applicable non-bankruptcy law. The operating expenses are to be necessary and directly related to the project or system generating the special revenues and are not the expenses of the municipality generally or for other systems or projects.

For reasons unique to municipalities, many financing leases are required to be subject to appropriation of the rent. These are generally marketed as debt obligations and treated as debt obligations for tax purposes. They should be treated in the same way for bankruptcy purposes and Section 928 so provides. The requirements of Section 365(d)(4) and 365(m) and the restriction on claims of Section 502(b)(6) are clearly not appropriate to this form of municipal debt.

SECTION 8

This section makes plans of adjustment subject to electoral or regulatory approval where required by non-bankruptcy law.

Many municipal actions require regulatory or electoral approval under constitutional, statutory or charter provisions. Also, there may be state or federal government regulatory approvals required. These approvals are not limited to rates but extend often to such other matters as the acquisition or disposition of property or the incurring of indebtedness. A plan of readjustment should not call for action to be taken without the requisite approval. Paragraph (6) does not require voter approval for the plan but only for actions to be taken under the plan which would require such approval if taken otherwise than under the plan.

VII. Agency Views

U.S. Department of Justice,
Office of Legislative and Intergovernmental Affairs,
Washington, DC, August 23, 1988.

Hon. Howell T. Heflin,
Chairman, Subcommittee on Courts and Administrative Practice, Committee on the Judiciary, U.S. Senate, Washington, DC.

Dear Mr. Chairman: This provides the views of the Department of Justice on S. 1863, a bill to amend the bankruptcy laws to provide for special revenue bonds and for other purposes.

Chapter 9 of the Bankruptcy Reform Act of 1978, P.L. 95-598, 92 Stat. 2549, 11 U.S.C. §101 *et seq.* (the "Code"), is entitled "Adjustment of Debts of a Municipality." Since a financially troubled municipality generally cannot liquidate its assets to satisfy its creditors, chapter 9 establishes a procedure within the confines of the federal bankruptcy court to allow a municipality to continue operating while it adjusts or refinancies creditor claims. *See* H.R. Rep. No. 595, 95th Cong., 2nd Sess. at 263 (1978). Incorporated by reference into chapter 9 are various provisions from other chapters of the Code. However, some of these more general provisions are not suitable to proceedings which must deal with the specialized financing mechanisms of a municipality. S. 1863 would harmonize the bankruptcy laws with the realities of municipal finance.

Sections 1 and 3 of S. 1863 replace the "assets versus liabilities" test for the purpose of determining eligibility for filing a chapter 9 petition. The new test would be patterned after that now provided in 11 U.S.C. §303(h)(1), i.e., the municipality's general failure to pay its indisputed debts as they become due. This change would recognize that many municipal assets (such as roads) have market values which are speculative at best. It also recognizes that, in any event, creditors are unlikely, and in most states constitutionally unable, to look to the liquidation of the municipality's assets to satisfy their obligations.

Section 2 recognizes that municipalities in many states are subject to rate regulation and that no particular reason exists for treating them differently from private entities subject to such regulation. The new section incorporates by reference 11 U.S.C. §1129(a)(6) which conditions confirmation of a plan by a debtor whose rates are regulated, upon approval of any governmental regulatory commission having jurisdiction.

Section 4 negates the possibility that the automatic stay might adversely affect the post-petition pledge of revenues recognized under the new section 927 which the bill would add (discussed below).

Section 5 excludes 11 U.S.C. §1111(b) from chapter 9. Generally, in the event of default on a non-recourse debt, the holder of a claim may only seek to collect against the property which has been given as security. In contrast, the holder of a claim constituting "recourse debt" may, upon default, seek collection from both the security and the debtor. These terms do not fit within the parameters of municipal finance. The nearest analogies are "special" obligations (often called "revenue bonds") which commit the repayment of a debt to the expected revenues of a particular project, and "gen-

eral" obligations, which make no such specific commitment. State constitutions or statutes frequently impose limitations on general obligations. Chapter 9 seemingly was not intended to eliminate these limitations but the incorporation of § 1111(b) might be construed to effect this result.

Section 1111(b) of the Code permits a creditor to elect to treat a non-recourse secured claim as a recourse claim for bankruptcy purposes. This right protects non-recourse debt holders from an undervaluation of their security which might appreciate in value over time. *See* 124 Cong. Rec. H11103 (September 28, 1978) (remarks of Rep. Edwards); 124 Cong. Rec. S17420 (October 6, 1978) (remarks of Sen. DeConcini). Debts of municipalities are not likely to be secured by the type of property which fluctuates in value because of ordinary market influences, to which the policy of section 1111(b) is directed. Moreover, security in municipal financing frequently consists of a pledge of revenues, rather than, for example, a mortgage of an apartment complex. *See In re Pine Gate Associates, Inc.*, 3 B.C.D. 838 (N.D. Ga. 1977). Section 5 of S. 1863 would make § 1111(b) inapplicable in chapter 9.

Section 6 of the bill would eliminate the preference provisions of section 547 of the Code in connection with a municipal bond or note to ensure consistency with current municipal financing mechanisms. Thus, revenues which are pledged as a result of a financing arrangement could be paid, and not voided, notwithstanding the fact that the revenues are received within 90 days of the filing of a bankruptcy petiton by a municipality.

Section 7 simply redesignates already existing sections to provide for newly added sections.

Section 8 modifies the application in chapter 9 of 11 U.S.C. § 552 to avoid potentially harmful effects upon municipal financing. In the private sector, creditors often take security interests in "after-acquired" property, that is, property which the debtor acquires after a loan is extended, in order to further secure a loan. Section 552 governs the effect of such security interests in property that is acquired after a debtor files a petition in bankruptcy. With certain exceptions, if a security agreement is executed before the filing of a petition, property acquired by the bankrupt estate after filing is not subject to the prepetition security interest.

Thus, section 552 arguably provides a mechanism for freeing municipalities from long-term pledges of revenues. But section 552 may prevent troubled municipalities from giving the kind of assurances that are necessary for continued financing. Since most municipalities cannot mortgage their real property, they must be able to offer other security which is valuable, even in the event of insolvency; hence, they pledge revenues. A municipality's ability to enter the financial markets and its cost of borrowing funds are dependent upon such assurances.

Section 552 might be construed to enable the municipality (or its general creditors) to avoid pledges as they apply to post-petition revenues. This would be inconsistent with the premise that the pledge should be protected against claims which are unrelated to the particular project, system or activity which generated the revenues and in many instances could result in the frustration of distinctions made by state constitutions and statutes between general

obligations and special obligations. Section 7 of S. 1863 would continue the security interest created by the pledge in revenues of a specific project or activity, subject only to the expenses of that project or activity. This is consistent with the language ordinarily included in revenue bonds. The continuation of the pledge should provide to revenue pledges sufficient protection from general creditors' claims to protect investors adequately and prevent discouragement of future investors.

In many instances—in addition to the setting of rates—municipal actions require regulatory or voter approval under State or local constitutional, statutory or charter provisions. Section 8 of S. 1863 recognizes these restrictions by providing for their observation as a condition of confirming a plan.

In addition to the foregoing substantive comments, we have some technical suggestions. Given the changes provided in sections 1 and 3 of the bill, section 109(b)(4) of the Code should be amended to substitute "its" for "such." It would thus read, "desires to effect a plan to adjust *its* debts." The language in section 3(3) of the bill is confusing. We suggest the introductory phrase "inserting before the paragraph redesignated above as paragraph (2)." Finally, section 901 incorporates by reference all of section 1102, which provides for the appointment of creditors' committees. Section 1102(a) provides that the United States Trustee appoints the committee members. Because chapter 9 does not provide otherwise for the involvement of the United States Trustee in the administration of municipal bankruptcies, we recommend language providing for the appointment of the committees by the court.

We believe these amendments will serve the fiscal interests of municipalities who finance public projects through revenue bonds and protect the expectations of persons investing in such bonds. Thus, these amendments will enhance the successful reoroganization of financially troubled municipalities in general. Accordingly, the Department of Justice recommends favorable consideration and prompt enactment of S. 1863.

The Office of Management and Budget has advised this Department that it has no objection to the submission of this report to Congress and that enactment of S. 1863 would be consistent with the Administration's objectives.

Sincerely,

JACK E. PERKINS
(For Thomas M. Boyd, Acting Assistant Attorney General).

VIII. COST ESTIMATE

In accordance with paragraph 11(a), Rule XXVI, of the Standing Rules of the Senate, the committee offers the Report of the Congressional Budget Office:

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, August 30, 1988.

Hon. JOSEPH R. BIDEN, Jr.,
Chairman, Committee on the Judiciary,
U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has reviewed S. 1863, a bill to amend the bankruptcy law to provide for special revenue bonds, and for other purposes, as ordered reported by the Senate Committee on the Judiciary, August 10, 1988. Enactment of this bill would result in no costs for the federal government, but could result in some savings for state and local governments. These savings are very uncertain, however, and depend on conditions and events that we cannot predict.

S. 1863 would amend the federal bankruptcy laws to clarify provisions concerning revenue bonds issued by municipalities and the separate rights of revenue and general obligation bond holders. (Revenue bonds are issued to finance a specific program or project and are secured by a lien on the revenues generated by the program or project, while general obligation bonds are secured by a pledge of the general taxing power of the issuer.) These amendments would resolve conflicts between the bankruptcy laws and state and local law governing municipal finance, and reduce investors' uncertainty.

Under existing conditions, enactment of this legislation probably would not have a significant impact on the cost of municipal debt, because the issues addressed by the bill are not a major factor affecting bond rates. It is possible, however, that a future legal ruling based on current law could undermine the security of bond holders and disturb the municipal bond market. All cities could then face higher borrowing costs and a city experiencing serious financial difficulties could find it very difficult or impossible to issue revenue bonds. By clarifying the law, S. 1863 should help to prevent this situation. The CBO cannot predict, however, whether such a situation would arise, or exactly how the markets would respond in the absence of this legislation.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contact is Marjorie Miller, who can be reached at 226-2860.

Sincerely,

C.G. NUCKOLS
(For James L. Blum, Acting Director).

IX. REGULATORY IMPACT STATEMENT

Pursuant to paragraph 11(b), Rule XXVI, of the Standing Rules of the Senate, the committee, after due consideration, concludes that the Act will not have direct regulatory impact.

X. CHANGES IN EXISTING LAW

In compliance with paragraph 12, Rule XXVI, of the Standing Rules of the Senate, changes in existing law made by S. 1863 are as follows: Existing law proposed to be omitted is enclosed in black brackets, new material is printed in italic, existing law in which no changes is proposed is shown in roman.

TITLE 11, UNITED STATES CODE

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CHAPTER 9—ADJUSTMENT OF DEBTS OF A MUNICIPALITY

Subchapter I—General Provisions

§ 901. Applicability of other sections of this title

(a) Sections 301, 344, 347(b), 349, 350(b), 361, 362, 364(c), 364(d), 364(e), 364(f), 365, 366, 501, 502, 503, 504, 506, 507(a)(1), 509, 510, 524(a)(1), 524(a)(2), 544, 545, 546, 547, 548, 549(a), 549(c), 549(d), 550, 551, 552, 553, 557, 1102, 1103, 1109, 1111(b), 1122, 1123(a)(1), 1123(a)(2), 1123(a)(3), 1123(a)(4), 1123(a)(5), 1123(b), 1124, 1125, 1126(a), 1126(b), 1126(c), 1126(e), 1126(f), 1126(g), 1127(d), 1128, 1129(a)(2), 1129(a)(3), *1129(a)(6),* 1129(a)(8), 1129(a)(10), 1129(b)(1), 1129(b)(2)(A), 1129(b)(2)(B), 1142(b), 1143, 1144, and 1145 of this title apply in a case under this chapter.

(b) A term used in section of this title made applicable in a case under this chapter by subsection (a) of this section or section 103(e) of this title has the meaning defined for such term for the purpose of such applicable section, unless such term is otherwise defined in section 902 of this title.

(c) A section made applicable in a case under this chapter by subsection (a) of this section that is operative if the business of the debtor is authorized to be operated is operative in a case under this chapter.

§ 902. Definitions for this chapter

In this chapter—

(1) "insolvent", notwithstanding section 101(31) of this title, when used in a section that is made applicable in a case under this chapter by section 103(e) or 901 of this title, means financial condition such that the municipality is generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute, or is unable to pay its debts as they become due;

[(1)**]** *(2)* "property of the estate", when used in a section that is made applicable in a case under this chapter by section 103(e) or 901 of this title, means property of the debtor;

(3) "special revenues" means—

(A) receipts derived from the ownership, operation, or disposition of projects or systems of the debtor that are primarily used or intended to be used primarily to provide transportation, utility, or other services, including the proceeds of borrowings to finance the projects or systems,

(B) special excise taxes imposed on particular activities or transactions,

(C) incremental tax receipts from the benefited area in the case of tax-increment financing,

(D) other revenues or receipts derived from particular functions of the debtor, whether or not the debtor has other functions, and

(E) taxes specifically levied to finance one or more projects or systems, but not including (except for tax-increment financing) receipts from general property, sales, or income taxes levied to finance the general purposes of the debtor.

[(2)] *(4)* "special tax payer" means record owner or holder of legal or equitable title to real property against which a special assessment or special tax has been levied the proceeds of which are the sole source of payment of an obligation issued by the debtor to defray the cost of an improvement relating to such real property;

[(3)] *(5)* "special tax payer affected by the plan" means special tax payer with respect to whose real property the plan proposes to increase the proportion of special assessment or special taxes referred to in paragraph (2) of this section assessed against such real property; and

[(4)] *(6)* "trustee", when used in a section that is made applicable in a case under this chapter by section 103(e) or 901 of this title, means debtor, except as provided in section 926 of this title.

§ 903. Reservation of State power to control municipalities

This chapter does not limit or impair the power of a State or control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality, including expenditures for such exercise, but—

(1) a State law prescribing a method of composition of indebtedness of such municipality may not bind any creditor that does not consent to such composition; and

(2) a judgment entered under such a law may not bind a creditor that does not consent to such composition.

§ 904. Limitation on jurisdiction and powers of court

Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with—

(1) any of the political or governmental powers of the debtor;

(2) any of the property or revenues of the debtor; or

(3) the debtor's use or enjoyment of any income-producing property.

Subchapter II—Administration

§ 921. Petition and proceedings relating to petition

(a) Notwithstanding sections 109(d) and 301 of this title, a case under this chapter concerning an unincorporated tax or special assessment district that does not have such district's own officials is commenced by the filing under section 301 of this title of a petition under this chapter by such district's governing authority or the board or body having authority to levy taxes or assessments to meet the obligations of such district.

(b) The chief judge of the court of appeals for the circuit embracing the district in which the case is commenced shall designate the bankruptcy judge to conduct the case.

(c) After any objection to the petition, the court, after notice and a hearing, may dismiss the petition if the debtor did not file the petition in good faith or if the petition does not meet the requirements of this title.

(d) If the petition is not dismissed under subsection (c) of this section, the court shall order relief under this chapter.

(e) The court may not, on account of an appeal from an order for relief, delay any proceeding under this chapter in the case in which

the appeal is being taken; nor shall any court order a stay of such proceeding pending such appeal. The reversal on appeal of a finding of jurisdiction does not affect the validity of any debt incurred that is authorized by the court under section 364(c) or 364(d) of this title.

§ 922. Automatic stay of enforcement of claims against the debtor

(a) A petition filed under this chapter operates as a stay, in addition to the stay provided by section 362 of this title, applicable to all entities, of—

(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against an officer, or inhabitant of the debtor that seeks to enforce a claim against the debtor; and

(2) the enforcement of a lien on or arising out of taxes or assessments owed to the debtor.

(b) Subsections (c), (d), (e), (f), and (g) of section 362 of this title apply to a stay under subsection (a) of this section the same as such subsections apply to a stay under section 362(a) of this title.

(c) If the debtor, under this section, or section 362 or 364 of this title, provides adequate protection of the interest of the holder of a claim secured by a lien on property of the debtor and if, notwithstanding such protection such creditor has a claim arising from the stay of action against such property under this section or section 362 of this title or from the granting of a lien under section 364(d) of this title, then such claim shall be allowable as an administrative expense under section 507(b) of this title.

(d) Notwithstanding section 362 of this title and subsection (a) of this section, a petition filed under this chapter does not operate as a stay of application of pledged special revenues in a manner consistent with section 927 of this title to payment of indebtedness secured by such revenues.

§ 923. Notice

There shall be given notice of the commencement of a case under this chapter, notice of an order for relief under this chapter, and notice of the dismissal of a case under this chapter. Such notice shall also be published at least once a week for three successive weeks in at least one newspaper of general circulation published within the district in which the case is commenced, and in such other newspaper having a general circulation among bond dealers and bondholders as the court designates.

§ 924. List of creditors

The debtor shall file a list of creditors.

§ 925. Effect of list of claims *and certain secured claims*

(a) A proof of claim is deemed filed under section 501 of this title for any claim that appears in the list filed under section 924 of this title, except a claim that is listed as disputed, contingent, or unliquidated.

(b) The holder of a claim payable solely from special revenues of the debtor under applicable nonbankruptcy law shall not be treated as having recourse against the debtor on account of such claim pursuant to section 1111(b) of this title.

§ 926. Avoiding powers

(a) If the debtor refuses to pursue a cause of action under section 544, 545, 547, 548, 549(a), or 550 of this title, then on request of a

creditor, the court may appoint a trustee to pursue such cause of action.

(b) A transfer of property of the debtor to or for the benefit of any holder of a bond or note, on account of such bond or note, may not be avoided under section 547 of this title.

§ 927. Post petition effect of security interest

(a) Notwithstanding section 552(a) of this title and subject to subsection (b) of this section, special revenues acquired by the debtor after the commencement of the case remain subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.

(b) Any such lien on special revenues, other than municipal betterment assessments, derived from a project or system is subject to the necessary operating expenses of such project or system, as the case may be.

§ 928. Municipal leases

A lease to a municipality shall not be treated as an executory contract or unexpired lease for the purposes of section 365 or 502(b)(6) of this title solely by reason of its being subject to termination in the event the debtor fails to appropriate rent.

[§ 927.] *§ 929.* Dismissal

(a) After notice and a hearing, the court may dismiss a case under this chapter for cause, including—

(1) want of prosecution;

(2) unreasonable delay by the debtor that is prejudicial to creditors;

(3) failure to propose a plan within the time fixed under section 941 of this title;

(4) if a plan is not accepted within any time fixed by the court;

(5) denial of confirmation of a plan under section 943(b) of this title and denial of additional time for filing another plan or a modification of a plan; or

(6) if the court has retained jurisdiction after confirmation of a plan—

(A) material default by the debtor with respect to a term of such plan; or

(B) termination of such plan by reason of the occurrence of a condition specified in such plan.

(b) The court shall dismiss a case under this chapter if confirmation of a plan under this chapter is refused.

§ 941. Filing of a plan

The debtor shall file a plan for the adjustment of the debtor's debts. If such plan is not filed with the petition, the debtor shall file such a plan at such later time as the court fixes.

§ 942. Modification of a plan

The debtor may modify the plan at any time before confirmation, but may not modify the plan so that the plan as modified fails to meet the requirements of this chapter. After the debtor files a modification, the plan as modified becomes the plan.

§ 943. Confirmation

(a) A special tax payer may object to confirmation of a plan.

(b) The court shall confirm the plan if—

(1) the plan complies with the provisions of this title made applicable by sections 103(e) and 901 of this title;

(2) the plan complies with the provisions of this chapter;

(3) all amounts to be paid by the debtor or by any person for services or expenses in the case or incident to the plan have been fully disclosed and are reasonable;

(4) the debtor is not prohibited by law from taking any action necessary to carry out the plan;

(5) except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the plan provides that on the effective date of the plan each holder of a claim of a kind specified in section 507(a)(1) of this title will receive on account of such claim cash equal to the allowed amount of such claim; [and]

(6) any regulatory or electoral approval necessary under applicable nonbankruptcy law in order to carry out any provision of the plan has been obtained, or such provision is expressly conditioned on such approval; and

[(6)] *(7)* the plan is in the best interests of creditors and is feasible.

§ 944. Effect of confirmation

(a) The provisions of a confirmed plan bind the debtor and any creditor, whether or not—

(1) a proof of such creditor's claim is filed or deemed filed under section 501 of this title;

(2) such claim is allowed under section 502 of this title; or

(3) such creditor has accepted the plan.

(b) Except as provided in subsection (c) of this section, the debtor is discharged from all debts as of the time when—

(1) the plan is confirmed;

(2) the debtor deposits any consideration to be distributed under the plan with a disbursing agent appointed by the court; and

(3) the court has determined—

(A) that any security so deposited will constitute, after distribution, a valid legal obligation of the debtor; and

(B) that any provision made to pay or secure payment of such obligation is valid.

(c) The debtor is not discharged under subsection (b) of this section from any debt—

(1) excepted from discharge by the plan or order confirming the plan; or

(2) owed to an entity that, before confirmation of the plan, had neither notice nor actual knowledge of the case.

§ 945. Continuing jurisdiction and closing of the case

(a) The court may retain jurisdiction over the case for such period of time as is necessary for the successful implementation of the plan.

(b) Except as provided in subsection (a) of this section, the court shall close the case when administration of the case has been completed.

§ 946. Effect of exchange of securities before the date of the filing of the petition

The exchange of a new security under the plan for a claim covered by the plan, whether such exchange occurred before or after the date of the filing of the petition, does not limit or impair the effectiveness of the plan or of any provision of this chapter. The amount and number specified in section 1126(c) of this title include the amount and number of claims formerly held by a creditor that has participated in any such exchange.

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